Building a hedge against disaster

Buying hedges may have paid off for some ILS managers in 2017, but Leadenhall Capital Partners CEO Luca Albertini argues that there are cheaper ways for investors to shield themselves against hurricane losses.

"We try to minimise the need for hedging by shaping the construction of our portfolio, rather than hedging and paying margin to another company," he explains.

Picking and choosing risk at different levels and across multiple geographies effectively provides a source of natural tail protection, reducing an ILS manager's potential worst-case losses.

While some industry loss warranty (ILW) or other hedges may have been activated by last year's catastrophes, such covers can be an expensive outlay for multiple years before the purchase pays off.

"If you want to maximise rate while minimising risk, hedging needs to be an opportunistic move, not a core part of the portfolio," Albertini argues.

Indeed, ILS managers have typically retained the bulk of the risk they write on a net basis, and many only began buying ILW cover in greater volumes in recent years as prices fell. This generally reflects a philosophy that their investors are expecting to take catastrophe risk – so the cards dealt by Mother Nature during the hurricane season should lie where they fall.

Ultimately the losses of 2017, coming after an unprecedented run of good luck for US coastal states in avoiding hurricanes strikes, have reminded investors that what they are investing in is "true risk", the Leadenhall CEO says.

"2017 was not a year you want to see repeated – but it shouldn't be repeated very often."

However, while 2017 may have cost ILS investors money, there could be an upside for the industry after having faced the tests of hurricanes Harvey, Irma and Maria.

Generally losses drive more purchasing of catastrophe cover and while it is early days for evidence of this trend, industry media have reported that the US National Flood Insurance Program lifted its protection for 2018, Albertini notes.

"We hope the coverage gap is reducing."

Moreover, many are hoping that ILS managers will have room to lift their share of the catastrophe reinsurance market after having smoothly managed the process of quickly raising fresh capital to meet claims and renew their portfolios in 2018.

"Some of the sceptics may be less concerned about the reliability of ILS capital now," believes Albertini.

But he also cautions against the industry pushing too quickly for growth in the wake of last year's losses.

Speaking several weeks after the January 2018 renewal season had concluded, the Leadenhall CEO suggested that the turnover of contract renewals highlighted examples of aggressive behaviour, with some underwriters looking to undercut broader rate increases to deploy larger volumes.

"We have lost \$50mn-\$60mn of renewal opportunities where we held out on pricing – mostly on large retrocession programmes," he explains.

"We're left with extra capacity to redeploy but we believe it was the right thing to do."

Building relationships with protection buyers should enable risk takers to gain some "payback" via higher premiums if they have sustained major losses, he argues.

"What we were talking about was relatively modest increases," he says.

Moreover, this undercutting could leave investors disappointed if they were promised certain increases in yields by managers that have not really attempted to deliver on those targets, he fears.

The issue highlights the complexity of the task facing ILS managers that were out fundraising in the last quarter of 2017 – they had to attempt to gauge what rate increases might be available to them at a time when there was uncertainty not only over the extent of losses, but also over how much capital their peers would raise.

This means that the process of fundraising must be an interactive one so that investors can provide a gauge of their minimal requirements, Albertini believes.

"We need to demonstrate the industry has robust pricing behaviour."

Fronting up

The ILS market may have proved its durability following last year's losses, but Albertini believes the industry can further develop its use of fronting relationships and rated facilities to help improve comfort levels over credit risk.

This could be crucial in years such as this, when ILS investors face the prospect of significant volumes of capital being locked up – not because they are expected to be lost, but because claims might be hovering near the threshold that would trigger a loss.

Leadenhall has access to fronting facilities via its parent company, MS Amlin, and it also gained a Standard & Poor's (S&P) rating last year on cat bond type instruments put in place to reinsure structures used by its funds.

This source of credit meant Leadenhall was able to roll forward capital which could otherwise have been locked to allocate against 2018 risks fronted for it by MS Amlin.

The ILS manager may have to provide more capital to MS Amlin if loss estimates deteriorate, but the S&P rating demonstrates to the reinsurer that the credit risk it is taking on across a large portfolio of assets is truly remote.

Similar use of credit ratings and risk analysis could help the ILS industry to measure the risks of catastrophe losses deteriorating to minimise trapped collateral.

It would not be about gaining leverage, Albertini says, but improving the understanding of the true counterparty risk of an ILS fund.

"If you look at our exceedance probability curve – a 1-in-10,000-year risk of exhausting capital is more than AAA level."

Another way that Leadenhall sought to minimise the level of illiquid, trapped capital was by waiting a couple of months after last year's major hurricanes before it set up side pockets for locked collateral.

The manager did not look to raise new capital into its commingled funds in September or October, which meant it could take that extra time while still ensuring level treatment for investors.

At the end of November, it established a side pocket for locked capital that was recorded in its October month-end result. Any changes to the valuation of this side pocket will be recorded in updates to the October headline result.

London bound

Harvey, Irma and Maria might have grabbed most of the ILS market's attention in 2017, but there was another topic that hit the headlines as well: the UK government's move to introduce a local regulatory framework to attract ILS business.

Albertini pored over draft documents for the new regime while it was under construction and says the firm will be looking to engage further with the regulator now that it is up and running.

"When you buy domestic you eliminate a level of complexity involved in cross-border transactions," he says. "All things being equal it facilitates business being simpler."

While it's not yet clear if the local framework will be suited to life ILS transactions, this is another area that Leadenhall has been expanding over the past year through the launch of a new closed-ended fund.

Life portfolios now make up $2bn of the firm's $4.7bn assets under management.

Across the industry, investors are coming in to life ILS funds with more long-term money and this is likely to give new energy to the life securitisation markets, Albertini believes.

"It may help to wake up more liquidity in the market."

In the life ILS market, where bilateral trades are much more frequent than in non-life catastrophe risks, the ability to execute and source risks is a crucial test of a manager's ability.

> "Hedging needs to be an opportunistic move"

But Albertini also suggests that this is true in the non-life reinsurance sector, given how much smaller the market is compared to broader financial industries.

Hence, while the reinsurance industry as a whole is currently focused on cutting costs from a historically high operating cost base, the Leadenhall CEO cautions investors that ILS funds are already operating at a low cost base, and further sharpening could come at the expense of underwriting rigour.

ILS managers are already much leaner than their reinsurance carrier peers, but Leadenhall is able to draw on MS Amlin's resources as well as its own analytics, he says.

This means the firm is able to reach counterparties who might have just five or six reinsurance writers on their core panel of providers. "There are hundreds of clients out there like that, but you need resources to reach out to them."

While the industry has to minimise costs at a time of pressure on returns, the ILS industry must make sure that any costs taken out are truly valueless, he argues.

"What we won't do is reduce underwriting expertise."